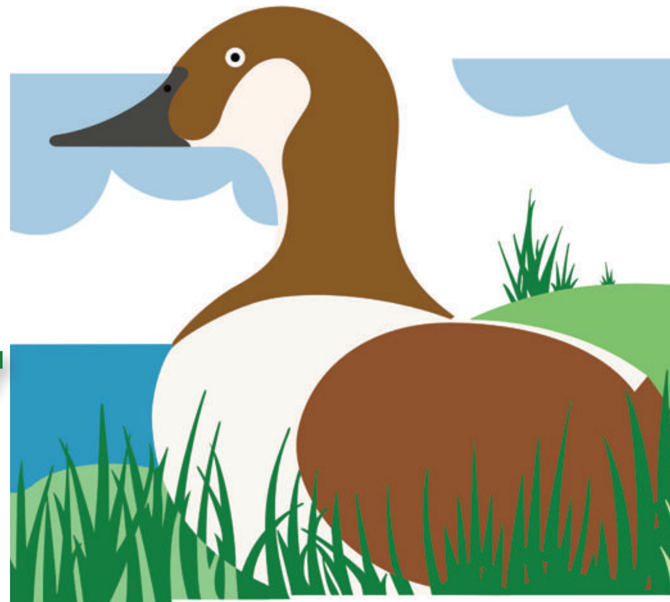
TAMING WILD CURRENCY PLAYS



Canadians are calling on their advisors to ferret out ways to capitalize on a rising greenback. But increasingly the success of any currency play in U.S. equities – particularly ETFs –depends on hedged or unhedged positioning. *WP*'s **Sophie Nicholls** uncovers the traps advisors are steering clear of

It may sound unpatriotic, but a falling loonie can reap higher returns. For your clients holding U.S. equities, that is. It's something, of course, you already know and thought about as Canada saw the dollar drop below $US0.90– compared to just over a year ago when the currencies sat virtually at par. Those clients holding U.S. stocks have won substantial gains against the loonie– upwards of 10 per cent in 2013. That trend line is expected to continue.

The Royal Bank announced in March that it expects the Canadian dollar to fall to 87 cents U.S. by the end of this year, and down to 85 cents by the end of 2015. The crystal balls of many economists are forecasting the same.

OPPORTUNITY SEIZED

Still, the resulting opportunities haven't been lost on investors, with a growing number now turning to their advisors with specific instructions: Make me money off that currency swing.

Wealth professionals haven't been slow to answer, although they are weighing the options and educating clients about the differences between hedged and unhedged positioning, especially given their ETF holdings.

"There are always options for investing in U.S. and foreign stock," says Barry Gordon, CEO and president of First Asset, one of Canada's leading ETF providers. "There are a range of choices available to the investor. It's getting more and more sophisticated, for sure."

A prime area where foreign currency exposure (or foreign exchange) is on the rise is in that same ETF segment as options expand and both U.S. and Canadian-listed ETFs grow their global investments. But the risks for these securities, as advisors point out, lie in their exposure to changes in the value of the loonie against those of the greenback. There's also the problem of the penalties incurred from currency-conversion costs.

According to Gordon, there are two roads advisors are taking their clients down when investing in foreign-exchange ETFs – hedged and unhedged. The former – no surprise – is the most commonly used of the two, effectively making currency irrelevant given the investment is, at the end of the day, in Canadian dollars.

"If you think about it, the logic behind that is, you are a Canadian investor, you

earn Canadian dollars, you spend money in Canadian dollars, you want exposure to foreign equities, why would you add the currency risk to that equation?" Gordon asks. "There is a strong philosophy and history behind that."

But the alternative is also finding its way into advisor-client discussions and, indeed, action plans. With unhedged investments, if your client, for example, invests in a Canadian ETF, which trades in Canadian dollars but holds stocks based in U.S. currency, they are subject to the fluctuation on the price of U.S. stock, but also affected by the value of the U.S. dollar versus the Canadian dollar. But if the stock value and currency both go up, bingo!

"If you are bullish on the U.S. market, then there is reason you should be bullish on the U.S. dollar, so you can benefit both ways," says Gordon. "Not only do you get the appreciation of the U.S. stocks, but you get the U.S. currency appreciation relative to the Canadian dollar. There's some logic there as well."

But advisors are actively pointing out the flip side for investors gung ho on both the greenback and the idea of a quick U.S. recovery; namely, if the U.S. stock goes up, but the currency dips, currency-related losses are inevitable.

For example:
"A conservative investor that owns a U.S. bond fund with an expected total return of 5 per cent might have that entire return washed away by a decline in the U.S. dollar against the Canadian dollar" – ***Michael Cooke***, head of Distribution, PowerShares Canada at Invesco

LEAD BY EXAMPLE

That's why advisors are erring on the side of caution with clients, ensuring they understand the impact of currency exposure and are weighing the potential losses against the more immediate profits before leading them down the unhedged path.

Rohit Mehta, First Asset's senior vice president, applauds that kind of active guidance on the part of advisors, suggesting it's absolutely key that they clients through the benefits of owning stock in companies in different markets, relative to the currency risk.

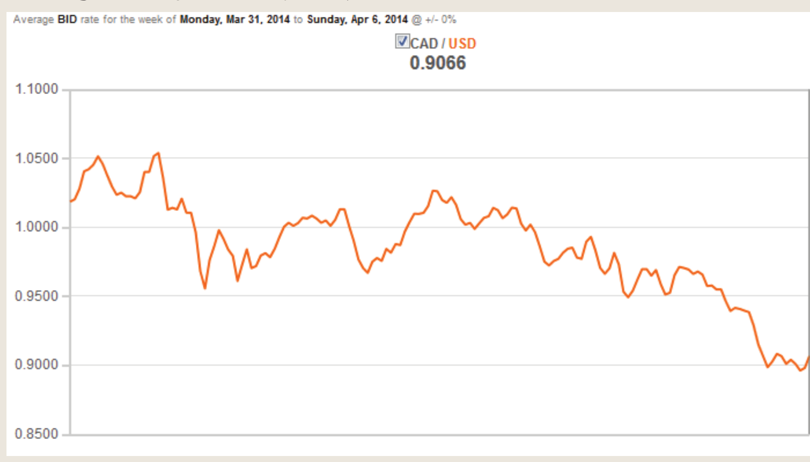
"If they (advisors) say, we are investing in these U.S. companies because we like the U.S. market recovery and we want to participate in it, full stop, then they should buy the hedged version and not care where the currency exchange rate in the U.S. goes," He offers.

Furthermore, when pursuing an unhedged approach, Mehta says, good advisors are investigating the foreign currency at hand, before making any recommendations to clients.

"Anytime you buying a Canadian ETF that is investing outside of Canada and you're buying it on an unhedged basis, you must have a view on the other currencies that that ETF is being exposed to," he says. "If you don't have a view on those currencies, don't take on that risk."

LOONIE SINGING A NEW TUNE

The Canadian dollar has trended up and down in relation to the greenback, although the expected trajectory in the short-term is southward



THE END RESULT

Whether pursuing a hedged or unhedged approach to foreign exchange investing, the result, if properly managed, remains the same – a diversified portfolio for the client.

"Canadian investors that own investment vehicles such as mutual funds or ETFs with unhedged exposure to other currencies such as the U.S. dollar assume foreign currency risk in their portfolios," says Cooke. "By viewing foreign exchange as a distinct asset class and by prudently allocating capital as with any other asset class, foreign exchange can improve portfolio diversification."

But, as Cooke and others points out, advisors already diversify client portfolios by blending different asset classes such as stocks, bonds and commodities based on it's the risk factors peculiar to any specific investment. Inevitably, even in the wild world of currency plays, the same holds true. WP